

REPORT BY THE
AUDITOR GENERAL
OF CALIFORNIA

**SOME PRO-RATA COSTS COULD BE
MORE EQUITABLY ALLOCATED**

REPORT BY THE
OFFICE OF THE AUDITOR GENERAL

F-542

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Telephone:
(916) 445-0255

STATE OF CALIFORNIA
Office of the Auditor General
660 J STREET, SUITE 300
SACRAMENTO, CA 95814

Thomas W. Hayes
Auditor General

February 28, 1986

F-542

Honorable Art Agnos, Chairman
Members, Joint Legislative
Audit Committee
State Capitol, Room 3151
Sacramento, California 95814

Dear Mr. Chairman and Members:

The Office of the Auditor General presents its report concerning the Department of Finance's methods of allocating overhead (pro-rata) costs. The Department of Finance could more equitably allocate some costs of Health Benefits for Retired Annuitants and the costs of providing personnel and payroll services to state agencies. For the fiscal years 1979-80 through 1984-85, actual statewide pro-rata costs increased by \$148 million. The pro-rata costs with the greatest increase was the Health Benefits for Retired Annuitants.

Respectfully submitted,

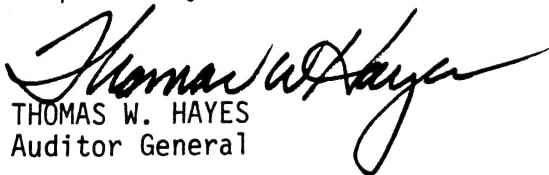

THOMAS W. HAYES
Auditor General

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SUMMARY

The Department of Finance's (department) methods of allocating overhead (pro-rata) costs appear reasonable and appropriate, with two exceptions. Some of the costs for Health Benefits for Retired Annuitants (HBRA) are inappropriately allocated to all state agencies. In addition, the costs of providing personnel and payroll services to state agencies would be more equitably allocated on the basis of personnel positions rather than personnel years, as the costs are now allocated.

The HBRA costs that are allocated to state agencies include the costs for retired judges, who are not retired state employees. The costs for the retired judges should be allocated to the Judges' Retirement System rather than to all state agencies. In fiscal year 1984-85, the health benefit costs for these retirees amounted to approximately \$960,000. In addition, pro-rata allocations include the costs of health benefits that the State pays for retirees of the district agricultural associations. Presently, these costs are not allocated to the district agricultural associations. The district agricultural associations should pay the health benefit costs of their retirees. For fiscal year 1984-85, the health benefit costs for retirees of the district agricultural associations amounted to approximately \$337,000.

As an alternative to the department's method, we developed a model to allocate pro-rata costs for HBRA. Our model distributes the costs for HBRA on the basis of the actual number of retirees from state agencies rather than the cost of health benefits for current employees. Except for the costs for health benefits for retired judges and retired employees of district agricultural associations, we believe that the department's current method equitably allocates the costs for HBRA to state agencies.

We also developed a model to allocate pro-rata costs for services to meet the personnel and payroll needs of state agencies. Our model measures the level of service provided to each state agency on the basis of personnel positions rather than personnel years. Our model resulted in an increase of \$830,900 (3.3 percent) to funds that are not billed for pro-rata costs and a decrease of \$830,900 (6.4 percent) to funds that are billed for pro-rata costs for fiscal year 1984-85. We believe that the costs for central services provided to state agencies are more equitably allocated under our model than they are under the department's current method of allocation.

To allocate other pro-rata costs, the department uses various workload measures that appear to be equitable. Periodically, the department adds new pro-rata costs or modifies the pro-rata calculation. These changes are made to comply with statutory requirements and to more equitably allocate pro-rata costs.

For fiscal year 1979-80 through 1984-85, actual statewide pro-rata costs increased by \$148 million. HBRA was responsible for the greatest increase in pro-rata costs. The increase in the costs for HBRA was due primarily to inflation in health care costs. The increase also reflects growth in the number of annuitants participating in the health plan and the addition of the dental plan.

INTRODUCTION

Thirteen executive state agencies, the Legislature, and the Office of the Auditor General provide various support services to state agencies. These entities, called "central service agencies," provide services such as financial, personnel, and legal support. The State Controller, for example, pays the State's bills and issues warrants for the State's payroll; the State Personnel Board assists state agencies in finding, selecting, retaining, and developing employees. If the State did not provide these support services centrally, the state agencies would have to provide them as part of their own operations. Table 1 lists the state entities that provide central services to other agencies.

TABLE 1

STATE ENTITIES PROVIDING CENTRAL SERVICES TO STATE AGENCIES

Department of Finance	Secretary of the Resources Agency
State Controller	Secretary of the Health and
State Treasurer	Welfare Agency
State Personnel Board	Secretary of the Youth and Adult
State Board of Control	Corrections Agency
Health Benefits for Retired	Secretary of the State and
Annuitants	Consumer Services Agency
Office of the Auditor General	Secretary of the Business,
Legislature	Transportation and Housing
Office of Administrative Law	Agency
Department of Personnel	
Administration	

Sections 11270 through 11277 and Section 22828.5 of the Government Code provide the State Board of Control with the statutory

authority to recover costs from certain funds for services provided to those funds by the central service agencies for the supervision or administration of the state government. These costs are called pro-rata costs. The State Board of Control contracts with the Department of Finance (department) to calculate how much each fund should pay for these services. This calculation is called the pro-rata assessment.

The department assesses all funds used to finance state operations, other than the General Fund, to reimburse the General Fund for services provided by the central service agencies. These funds are called billable funds. Funds that do not reimburse the General Fund are called nonbillable funds. Nonbillable funds are those funds that either receive their income from the General Fund or are not used to support state operations. Funds that are not used to support state operations do not reimburse the General Fund because pro-rata assessments pertain only to costs associated with state operations.

To determine the pro-rata assessment to billable funds, the department allocates pro-rata costs to both billable and nonbillable funds. However, the department assesses only billable funds. Approximately 30 percent of total pro-rata costs are allocated to billable funds; the remaining 70 percent are allocated to nonbillable funds. After determining pro-rata assessments, the department submits them to the State Board of Control for approval.

The department uses a three-step process in allocating pro-rata costs to funds. In the first step, the department allocates estimated pro-rata costs for the year in which funds will be assessed--the assessment year--using units of service provided to state agencies. These units of service are called workload measures. The department obtains the estimated pro-rata costs and the workload amounts from the central service agencies and from the Governor's Budget. (The workload measures used to allocate the various pro-rata costs are shown in Appendix A.)

In the second step, the department adjusts its allocation for overestimates and underestimates of pro-rata costs for the prior year, which is the second year preceding the assessment year. This adjustment is called the prior-year adjustment. Cost information from the prior year is the most recent actual cost information available. The department calculates the prior-year adjustment by subtracting estimated pro-rata costs for the prior year from actual pro-rata costs for the prior year. Table 2 illustrates this calculation:

TABLE 2
CALCULATION OF PRIOR YEAR ADJUSTMENT

	(A)	(B)	(C)
	1984-85 <u>Actual Costs</u>	1984-85 <u>Estimated Costs</u>	1986-87 Prior Year Adjustment <u>[(A) - (B)]</u>
State agency's Pro-rata Costs	\$6,000	\$3,500	\$2,500

Because the estimates of pro-rata costs are made two years in advance, significant differences may occur between estimated and actual pro-rata costs. Prior year adjustments may be necessary when the department or the central service agencies do not accurately estimate future costs, when the central service agencies do not accurately estimate future workloads, when the department adds new pro-rata costs to the pro-rata process, or when central service agencies' activities change significantly.

To allocate the prior-year adjustment to state agencies, the department uses the same method it uses to allocate estimated pro-rata costs for the assessment year. The department obtains prior-year estimates from its records and obtains prior-year actual costs from the central service agencies. (Total prior-year adjustments for various pro-rata costs are shown in Appendix D.)

In the third step, the department distributes the adjusted allocation among all funds within each state agency. The department bases this distribution on the proportion of each fund's net state operations within the agency. Net state operations expenditures are used for this distribution because workload amounts by fund are not available for every central service. Table 3 illustrates step three of the pro-rata process.

TABLE 3
ALLOCATION TO FUNDS WITHIN STATE AGENCIES

<u>Funds Within the State Agency</u>	(A) <u>Fund's Proportion of State Agency's Net State Operations Dollars</u>	(B) <u>State Agency's Pro-Rata Costs</u>	(C) <u>Fund's Pro-Rata Costs [(A) x (B)]</u>
Fund #1	70%	\$1,000	\$700
Fund #2	30%	\$1,000	\$300

A fund's pro-rata costs will increase when pro-rata costs increase for the agency as a whole or when the fund's proportion of agency net state operations expenditures increases. As we explained earlier, although pro-rata costs are allocated to all funds, only billable funds are assessed for pro-rata costs.

SCOPE AND METHODOLOGY

The purpose of this audit was to determine whether the method used by the department to assess pro-rata costs is appropriate and

reasonable. To make this determination, we reviewed the department's method of calculating pro-rata costs, analyzed recent increases in pro-rata costs, analyzed the pro-rata costs allocated to 12 billable funds, and considered alternate methods to allocate the costs of Health Benefits for Retired Annuitants (HBRA) and the costs of central service agencies that provide personnel and payroll services to state agencies.

To learn the details of the pro-rata calculation and recent changes to the calculation, we interviewed department staff and reviewed department documentation.

To analyze recent increases in pro-rata costs, we analyzed actual costs of central service agencies for fiscal year 1979-80 through 1984-85. Because pro-rata assessments are a combination of estimated and actual costs, we also analyzed prior-year adjustments for the same fiscal years. We obtained the pro-rata costs and prior-year adjustments from the department.

We analyzed the pro-rata costs of 12 billable funds accounted by a single agency and primarily supported by industry groups to determine if each fund is allocated pro-rata costs proportionately. We obtained the pro-rata costs and workload amounts from the department and from the Governor's Budget for each of the fiscal years we reviewed.

We developed two models to show the effect of using different workload measures to distribute certain pro-rata costs. In the first model, we based our allocation of fiscal year 1984-85 actual costs for HBRA on the number of retirees from each agency. We compared this method to the department's method, which is based on the health benefit costs of current employees. We obtained fiscal year 1984-85 actual costs for HBRA from the department and the number of retirees of each agency from the Public Employees Retirement System.

Although we allocated the cost of HBRA on the basis of the number of retirees from each state agency, we considered allocating these costs based on the period of time an employee is employed at each state agency. However, the information needed to allocate the pro-rata costs on this basis is not readily available, nor is it economically feasible to obtain it.

In the second model, we based our allocation of fiscal year 1984-85 actual costs of the State Controller's Personnel and Payroll Services Division, the State Personnel Board, the Department of Personnel Administration, and the State Board of Control on personnel positions for each state agency. We compared this method of allocating costs to the department's method, which is based on personnel years. We obtained fiscal year 1984-85 actual costs for the various central service functions from the department and the personnel positions for each state agency from the State Controller's Personnel and Payroll Services Division.

AUDIT RESULTS

I

A REVIEW OF THE PRO-RATA PROCESS

The Department of Finance (department) uses various workload measures to allocate pro-rata costs. Periodically, the department adds new pro-rata costs or modifies the pro-rata calculation. We found the department's allocation of pro-rata costs to be appropriate and reasonable, with two exceptions. The department should not allocate to all state agencies certain costs for Health Benefits for Retired Annuitants (HBRA). Also, a more equitable workload measure could be used to allocate costs of central service agencies that provide personnel and payroll services to state agencies. Except for these two factors, the department's method of allocating pro-rata costs reasonably ensures that billable funds appropriately reimburse the General Fund for services provided to them by central service agencies. Since billable funds represent approximately 30 percent of total statewide operations, these funds pay approximately 30 percent of the pro-rata costs. The General Fund bears the remaining 70 percent.

In the six years between fiscal year 1979-80 and 1984-85, total actual statewide pro-rata costs increased by \$148 million, from \$113 million to \$261 million. The pro-rata costs for HBRA showed the greatest increase, primarily because of inflation in health care costs. However, the increase also reflects growth in the number of annuitants

participating in the health plan and the addition of a dental plan. These factors that contributed to the increased pro-rata costs for HBRA also caused large prior-year adjustments for HBRA. From fiscal year 1979-80 through 1984-85, the total prior-year adjustments for all pro-rata costs combined ranged from \$3.6 million (1.6 percent of actual costs) in fiscal year 1983-84 to \$29 million (20.2 percent of actual costs) in fiscal year 1980-81. The largest prior-year adjustment of all pro-rata costs during the six-year period, \$16 million in fiscal year 1982-83, was for HBRA.

Allocation to Agencies

The department uses various workload measures to allocate pro-rata costs to state agencies. Although Sections 11270 through 11277 and Section 22828.5 of the Government Code provide the statutory authority to recover pro-rata costs from certain funds, they do not specify the allocation method or the workload measures to be used. Within the broad guidelines stated in the Government Code, the department uses the following workload measures to allocate the costs of all central service agencies except the Legislature: hours worked, documents processed, interest earned on investments in the Surplus Money Investment Fund, personnel years, gross state operations expenditures, and current employee health costs. The department allocates the Legislature's costs using the amount of all other pro-rata costs allocated. (See Appendix A for a list of costs allocated to central service agencies for each of the seven workload measures.)

Hours Worked/Documents Processed/
Interest Earned

The department allocates some pro-rata costs using workload measures that directly relate to the central service provided. For example, the department allocates the costs of the State Controller's field audits using audit hours spent at each state agency. The allocation of these costs is based on the following formula:

$$\begin{array}{ccccc} \text{Cost to} & & \text{Cost per} & & \text{Audit hours spent} \\ \text{state agency} & = & \text{audit hour} & \times & \text{at the state agency} \end{array}$$

The cost per audit hour is the total cost of State Controller's field audits divided by the total audit hours spent at all state agencies.

Two examples of pro-rata costs that are allocated using a workload measure that directly relates to the central service provided are the State Controller's general disbursement costs, which are allocated according to the number of warrants issued, and the costs of the Office of Administrative Law, which are allocated according to the number of review hours. The department receives this workload information from the central service agencies. Costs allocated using workload measures that relate directly to the central service provided represent 15.90 percent of total actual pro-rata costs for fiscal year 1984-85.

Personnel Years

The department uses personnel years to allocate the costs of central service agencies, such as the State Personnel Board, that meet the personnel and payroll needs of state agencies. A personnel year represents the portion of a position expended for performance of work. For example, a full-time position that is filled half the year equals .5 personnel years. The department uses the following formula to allocate the costs of the State Personnel Board.

$$\begin{array}{lcl} \text{Cost to} & & \text{Cost per} \\ \text{state agency} & = & \text{personnel year} \end{array} \quad \times \quad \begin{array}{l} \text{Number of} \\ \text{personnel years} \\ \text{at the state agency} \end{array}$$

The cost per personnel year for the services of the State Personnel Board equals the total costs of the State Personnel Board divided by the sum of the personnel years of all state agencies. The department obtains data on personnel years from the Governor's Budget. Costs that are allocated using personnel years represent 14.48 percent of total actual pro-rata costs for fiscal year 1984-85.

Using personnel years to allocate pro-rata costs may lead to inequity because processing costs for each employee are approximately the same whether an employee works full time or part time. For this reason, we developed a model for allocating pro-rata costs that uses personnel positions rather than personnel years as the workload measure. Our model equates each position, whether full-time or

part-time, with one employee. The results of applying our model are explained in Part II of this report.

Gross State Operations Expenditures

The department allocates some pro-rata costs, such as those for the California Fiscal Information Systems (CFIS) and the California State Accounting and Reporting System (CALSTARS) on the basis of gross state operations expenditures. The department uses this workload measure because there is no other workload measure that can be easily identified with these pro-rata costs. The following formula is used to allocate these pro-rata costs:

$$\begin{array}{lcl} \text{Cost to} & & \\ \text{state agency} & = & \begin{array}{l} \text{Cost per dollar of} \\ \text{gross state operations} \\ \text{expenditures} \end{array} \times \begin{array}{l} \text{Gross state operations} \\ \text{expenditures for} \\ \text{the state agency} \end{array} \end{array}$$

The cost per dollar of gross state operation expenditures for CFIS, for example, is calculated by dividing the total costs of CFIS by the total gross state operation expenditures for all state agencies. Costs that are allocated on the basis of gross state operations expenditures represent 4.09 percent of total actual pro-rata costs for fiscal year 1984-85.

Although not all state agencies use the CALSTARS, the department allocates the cost of the CALSTARS to all state agencies except those that have their own automated accounting systems. The

department uses this method of allocation because most state agencies will be using the CALSTARS in the future and will, therefore, benefit from the development and implementation of this new system. The CALSTARS represents less than 2 percent of total actual pro-rata costs for fiscal year 1984-85.

Health Benefits for Retired Annuitants

At present, the department uses the costs of health benefits for current employees to allocate the costs for HBRA. The following formula illustrates this allocation.

$$\begin{array}{lcl} \text{Cost to} & & \text{Cost of HBRA per dollar} \\ \text{State agency} & = & \text{of health benefit} \\ & & \text{expenditure for} \\ & & \text{current employees} \end{array} \quad \times \quad \begin{array}{l} \text{Health benefit} \\ \text{expenditures for} \\ \text{current employees} \\ \text{of the state agency} \end{array}$$

The cost of HBRA per dollar of health benefit expenditures for current employees equals total costs for HBRA divided by the total health benefit costs of current employees at all state agencies.

The department formerly used personnel years as the workload measure to allocate the cost of HBRA but changed its method to exclude seasonal employees who usually do not qualify for retirement benefits. These costs represent 39.07 percent of total actual pro-rata costs for fiscal year 1984-85.

To determine whether the allocation method that the department currently uses is equitable, we developed an alternate model to allocate HBRA costs and used the actual number of each agency's retirees as the workload measure. In Part II of this report, we discuss this model.

Legislature

The department allocates only 50 percent of legislative costs because some legislative costs relate to resolutions and other matters that do not benefit state agencies. The Legislature's central service costs do not include costs for the Office of the Auditor General since these costs are allocated to state agencies separately on the basis of audit hours.

The department uses the sum of all other pro-rata costs to allocate the Legislature's costs because it is difficult to measure the time the Legislature spends on work for each agency. In addition, the amount of work performed on behalf of state agencies is not related to the size of each state agency's budget, so state operations expenditures would not be an accurate workload measure. The department uses the following formula to allocate the Legislature's costs.

$$\begin{array}{lcl} \text{Cost to} & & \\ \text{state agency} & = & \frac{1}{2} \times \text{legislative} \\ & & \text{costs per} \\ & & \text{dollar of} \\ & & \text{nonlegislative} \\ & & \text{pro-rata costs} \end{array} \quad \times \quad \begin{array}{l} \text{A state agency's} \\ \text{nonlegislative} \\ \text{pro-rata costs} \end{array}$$

The legislative cost per dollar of nonlegislative pro-rata costs equals one-half of the total cost of the Legislature divided by the sum of all other pro-rata costs. These costs represent 26.46 of total actual pro-rata costs for fiscal year 1984-85.

Changes in the Pro-rata Calculation

The department periodically adds new pro-rata costs or modifies the pro-rata calculation. For example, in fiscal year 1981-82, the department added the costs of the CALSTARS service and the State Controller's field audits service. Section 11270 of the Government Code, as amended in 1981 and 1982, recognized as administrative costs the costs of the Office of Administrative Law and the agency secretaries. In fiscal year 1984-85, the 1983-84 additions to the pro-rata costs represented \$6.3 million or 2.4 percent of the total pro-rata costs. (The effects of adding the costs of the Office of Administrative Law and the agency secretaries are shown in Appendix B.)

In fiscal year 1984-85, the department changed the workload measures used to allocate the pro-rata costs for HBRA and the State Treasurer's trust services. Although these changes do not increase total pro-rata costs, they do result in state agencies' paying different shares of the total cost.

The department formerly used personnel years to allocate costs for HBRA. Under this method, seasonal employees were a factor in the calculation of pro-rata costs. However, even though seasonal employees may qualify for health benefits upon retirement, few actually receive these benefits. To eliminate seasonal employees from the pro-rata calculation, in fiscal year 1984-85, the department began allocating costs for HBRA on the basis of health benefit costs for current employees, since few seasonal employees qualify for current benefits. We concur with the department's change.

This change in workload measure reduced the pro-rata costs for HBRA for those state agencies that had a large percentage of seasonal employees. Two of the agencies whose pro-rata costs for HBRA decreased greatly were the Department of Parks and Recreation and the Employment Development Department, both of which employ many seasonal employees.

The second change affects the allocation of costs for the State Treasurer's trust services. The department formerly based its allocation of these costs on the share of interest earned by each agency on its deposits in the Surplus Money Investment Fund. Some, but not all, agencies have deposits in the Surplus Money Investment Fund to earn interest income. The department now allocates the costs for the State Treasurer's trust services using gross state operations expenditures because the State Treasurer's trust services benefit all funds, not just those with deposits in the Surplus Money Investment Fund. Because the State Treasurer's trust services costs represent

less than one-half of one percent of total actual pro-rata costs for fiscal year 1984-85, this change had little effect on any agency's pro-rata costs.

Statewide Pro-rata Costs Have Increased

In the six years between fiscal year 1979-80 and 1984-85, total actual statewide pro-rata costs increased by \$148 million, from \$113 million to \$261 million. This increase in costs represents an average annual increase of 15 percent. During the same period, the pro-rata actual costs to billable funds increased by \$52 million, from \$33 million in fiscal year 1979-80 to \$85 million in fiscal year 1984-85. This increase in pro-rata assessments represents an average annual increase of 17 percent. (Appendix B shows the total cost incurred by each central service agency for fiscal years 1979-80 to 1984-85, as well as the actual costs to billable and nonbillable funds during the same period.)

Between fiscal year 1979-80 and 1984-85, HBRA was responsible for the greatest increase in pro-rata costs. The pro-rata costs for this program increased by \$72.2 million, from \$29.8 million in fiscal year 1979-80 to \$102 million in fiscal year 1984-85, an average annual increase of 23 percent. During this same period, the General Fund state operations expenditures increased at an average annual rate of 7 percent. All other pro-rata costs, excluding new pro-rata costs added after fiscal year 1979-80, increased by \$57 million, from \$83 million

in fiscal year 1979-80 to \$140 million in fiscal year 1984-85. This change represents an average annual increase of 9 percent, which closely parallels the increase in state operations expenditures of the General Fund.

The addition of new central service agencies and expanded functions of existing central service agencies increased total statewide pro-rata costs by \$19 million during the same period. New services offered by the Department of Finance and the State Controller's office account for \$8 million of this increase, and the services of new central service agencies account for the remaining \$11 million. (Appendix C summarizes the actual costs of each central service agency and the percentage increase for each fiscal year from 1979-80 through 1984-85.)

Because pro-rata costs for HBRA increased by the greatest amount, and the other pro-rata costs, excluding new pro-rata costs added after fiscal year 1979-80, increased at a rate approximating the increase in state operations expenditures of the General Fund, we focused our analysis on HBRA.

The HBRA program, which began on January 1, 1962, with an employer contribution of \$5 per month, pays for health and dental insurance premiums for annuitants of retirement systems to which the State contributes as an employer. These systems are the Judges', Legislators', Public Employees', and State Teachers' retirement

systems. Since 1962, major medical plans, Medicare, and plans supplementing Medicare have been added. Dental care was added on July 1, 1981, and became effective on January 1, 1982, after open enrollment was completed. Costs for HBRA are subject to statutory changes.

Section 22825.1 of the Government Code expresses legislative intent that the State pay an average of 100 percent of health insurance costs for active employees and annuitants and 90 percent of health insurance costs for the dependents of employees. Since insurance carriers increased the premium rates for health benefits for fiscal year 1984-85, an increase in the maximum employer contributions was required to maintain the average 100/90 level. Chapter 258, Statutes of 1984, provided money to increase the State's maximum monthly contribution to \$86 for a single enrollee, \$167 for an enrollee and one dependent, and \$209 for an enrollee and two or more dependents. Section 22953 of the Government Code and Chapter 1513, Statutes of 1984, permitted annuitants who retired before January 1, 1982, the effective date of the state dental program, the same dental benefits provided to all other employees.

Between fiscal year 1979-80 and 1984-85, the increases in costs for HBRA were due primarily to inflation in health care costs. However, the increase also reflects growth in the number of annuitants participating in the health plan and the addition of the dental plan. Health benefit costs for annuitants represent \$35.1 million

(48.6 percent) of the increase. The average annual cost per annuitant, not including dental benefits, increased by \$822 (117 percent) from \$698.25 in fiscal year 1979-80 to \$1,519.50 in fiscal year 1984-85. According to the Health Insurance Association of America, between 1978 and 1983, health insurance premiums in the United States increased 92.1 percent. In addition, the average annual number of annuitants increased by 17,459 (41 percent) from 42,749 in fiscal year 1979-80 to 60,208 in fiscal year 1984-85. This growth in the plan was responsible for \$26.5 million (36.8 percent) of the increase in costs for HBRA. Finally, the addition of dental benefits resulted in \$10.6 million (14.6 percent) of the increase.

In his Analysis of the Budget Bill for the fiscal year 1985-86, the Legislative Analyst suggested that the Legislature consider ways to contain the cost of HBRA. The Legislative Analyst advised the Legislature to consider limiting health care expenditures for short service employees while continuing to reward those with longer service. The Legislative Analyst also suggested that the State and the annuitants share the costs of health benefit premiums.

Differences Between Estimated and Actual Pro-rata Costs

Between fiscal year 1979-80 and 1984-85, the total prior-year adjustments for all pro-rata costs combined ranged from \$3.6 million (1.6 percent of actual costs) in fiscal year 1983-84 to \$29 million (20.2 percent of actual costs) in fiscal year 1980-81. The largest

prior-year adjustment, \$16 million, was for HBRA in fiscal year 1982-83. This adjustment occurred for the same reasons that actual costs for HBRA increased. (See Appendix D for a summary of prior-year adjustments to the pro-rata costs for fiscal years 1979-80 to 1984-85.)

Large prior-year adjustments have two negative effects. First, they result in cash flow problems for some billable funds that receive funding in the first year for a specific purpose, spend it for the designated purpose, and are later charged for prior-year pro-rata costs after they have spent their funding. Second, if prior-year adjustments are a result of underestimated pro-rata costs, prior-year adjustments result in interest-free loans to billable funds, since the General Fund is not reimbursed until two years after it incurred the costs. On the other hand, if prior year adjustments are a result of overestimated pro-rata costs, the General Fund benefits. As indicated in Appendix D, from fiscal year 1979-80 through 1984-85, net prior-year adjustments were a result of underestimated pro-rata costs.

Pro-rata Costs of Funds Primarily Supported by Industry Groups

We analyzed the pro-rata costs of 12 funds accounted by a single agency and primarily supported by industry groups, such as the Agriculture Fund and the Savings and Loan Inspection Fund. To determine whether these funds were allocated pro-rata costs proportionately, we compared the percentage of each fund's pro-rata costs to each fund's state operations expenditures for fiscal year

1979-80 through 1984-85. We found that the percentages were very similar for all funds, ranging from 2.68 percent to 3.75 percent. (Appendix E shows the percentage of pro-rata costs allocated on the basis of net state operations expenditures for fiscal years 1979-80 to 1984-85 for the 12 funds we analyzed.)

Because the allocation of a state agency's pro-rata costs to funds within the state agency is based on each fund's proportion of net state operations expenditures, the increases in a fund's pro-rata costs may be the result of a change in this ratio. The ratio may change because a state agency's funding sources have changed or because expenditures in the Governor's Budget have been reclassified. For example, in fiscal year 1983-84, the proportion of net state operations expenditures of the Public Utilities Commission Utilities Reimbursement Account increased because the General Fund was no longer used as a funding source for the Public Utilities Commission. As a result, the net state operations expenditures of the Public Utilities Commission Utilities Reimbursement Account represented a larger percentage of the Public Utility Commission's net state operations expenditures.

The Agriculture Fund's proportion of the Department of Food and Agriculture's net state operations expenditures increased in fiscal year 1983-84 because a presentation change in the Governor's Budget added \$15 million to the net state operations of the Agriculture Fund for a continuing appropriation that was not included in the Governor's Budget in previous years. As a result of this change, the Agriculture

Fund was charged for 50 percent of the total pro-rata costs charged to the Department of Food and Agriculture rather than the 40 percent it would have been charged had a change not been made, an increase of \$291,000.

II

SOME PROPOSED CHANGES TO THE CURRENT PRO-RATA PROCESS

The department currently allocates the costs for HBRA on the basis of the costs for health benefits for current personnel. In addition, the department includes the costs for health benefits for retired judges and retired employees of district agricultural associations, even though judges are not retirees from state agencies and the department does not allocate pro-rata costs for HBRA to district agricultural associations. Under the department's method, state agencies are inappropriately charged for health benefits for retired judges and retired employees of the district agricultural associations. To eliminate this inequity, we developed a model to allocate the costs of HBRA on the basis of the number of an agency's retirees and compared the results with the department's method.

We also developed an alternative to the department's method of calculating pro-rata costs for the personnel and payroll needs of state agencies. The department currently allocates the pro-rata costs for these services on the basis of personnel years. We used personnel positions as the workload measure to allocate costs for the personnel and payroll needs of state agencies and compared the results of our method with those of the department. We believe that personnel positions is a more equitable workload measure than personnel years because personnel positions more fairly measure the services provided to each agency.

Health Benefits for
Retired Annuitants Model

The model we developed to allocate the costs of HBRA for fiscal year 1984-85 differs in two ways from the department's method. First, we eliminated the costs charged to all state agencies for retired judges and retirees of the district agricultural associations. Second, we used the number of an agency's retirees, rather than its costs for the health benefits for current personnel, to calculate the agency's pro-rata costs for HBRA.

The department currently allocates certain costs as part of pro-rata costs of HBRA that we believe should not be charged to all state agencies. The cost of health benefits that the State pays for retired judges should not be part of pro-rata costs charged to state agencies because these retirees are not retired state employees. Instead, these costs should be charged to the Judges' Retirement System. For fiscal year 1984-85, the costs of health benefits for retired judges were approximately \$960,000. In addition, the pro-rata costs for HBRA include the costs of health benefits that the State pays for retirees of the district agricultural associations. Although these retirees were state employees when employed by the district agricultural associations, the department does not assess the district agricultural associations pro-rata costs for HBRA. For fiscal year 1984-85, the costs of health benefits for retirees of the district agricultural associations were approximately \$337,000.

Using our model, we also determined the difference between calculating pro-rata costs for HBRA for fiscal year 1984-85 on the basis of an agency's costs for health benefits for current personnel, as the department now does, and on the basis of the number of retired personnel of an agency. According to our calculations, there was a minor increase of \$1,050,664 (3.1 percent) to billable funds and a decrease of \$1,050,664 (1.5 percent) to nonbillable funds for health benefits costs. This difference occurred because using a different workload measure redistributed the cost from agencies primarily funded by nonbillable funds to those primarily funded by billable funds.

Under the department's method of allocating the costs of HBRA, the costs allocated to a state agency are determined by the state agency's costs for health benefits for current personnel. When an agency has an increase or a decrease in costs for health benefits for current personnel, the agency's pro-rata costs for HBRA will increase or decrease accordingly.

A comparison of the results of our model with the department's current method of allocating health benefit costs for three state agencies illustrates the difference between the two methods. In 1964-65, the Department of Mental Hygiene and the Employment Development Department (EDD) had 14.5 percent and 5.4 percent, respectively, of the total state personnel. In 1984-85, the Department of Mental Health and the Department of Developmental Services (which, together, provide the services formerly provided by the Department of

Mental Hygiene) had only 8 percent of the total state personnel, and the EDD had only 4.8 percent of the total state personnel. Because they had a larger share of personnel 20 years ago, today these departments have a larger share of retirees. Therefore, under our model, pro-rata costs allocated to these departments increased, compared to their allocation under the current method. In our model, the EDD was charged 8.6 percent of the pro-rata costs for HBRA. The Department of Mental Health and the Department of Developmental Services, together, were charged 14.7 percent. In the department's current method, the EDD was charged 6.7 percent; the Department of Mental Health and the Department of Developmental Services, together, were charged 10.5 percent.

In contrast, the Department of Corrections (DOC) had 4.3 percent of the total state personnel in 1964-65; today it has 5.9 percent of the total state personnel. The DOC's pro-rata costs were reduced in our model because retirees from the DOC represent a smaller percentage of state retirees, while its current personnel represent a larger percentage of total state personnel. In our model, the DOC was charged 6.6 percent of the pro-rata costs for health benefits; in the department's current method, it was charged 8.3 percent.

Personnel Services Model

The department allocates the costs related to central services to meet the personnel and payroll needs of state agencies on the basis of personnel years, which represent full-time equivalent positions. That is, a full-time position that was filled only one-half of the year or a half-time position that was filled the entire year equals .5 of a personnel year. In our model, a position filled by either a full-time or a part-time employee equals one personnel position.

We believe that personnel positions is a more equitable workload measure than personnel years because personnel positions more fairly measure the services provided to each agency. The central service agencies provide personnel and payroll services to other state agencies regardless of the employee's status with the state agency. For example, the State Controller's Personnel and Payroll Services Division processes personnel documents such as the Report of Appointment and the Employee Transfer Data form. The same documents are required whether a full-time or part-time employee is hired or terminated. The State Personnel Board also provides the same services for both full-time and part-time employees. This agency assists other state agencies in hiring new staff by testing and interviewing applicants for both part-time and full-time positions with the State.

Using our model, we determined the difference between calculating pro-rata costs for meeting the personnel and payroll needs

of state agencies for fiscal year 1984-85 on the basis of the number of personnel years of an agency, as the department now does, and on the basis of the number of personnel positions of an agency. According to our calculations, there was an increase of \$830,946 (3.3 percent) to nonbillable funds and a corresponding decrease of \$830,946 (6.4 percent) to billable funds for costs for personnel and payroll services. This difference occurred because using a different workload measure redistributed the cost from agencies primarily funded by billable funds to those primarily funded by nonbillable funds. Although the cumulative difference between our model and the department's method was minor, there were significant differences for some agencies. Table 4 below shows the number of agencies whose pro-rata costs either increased or decreased under our model and the ranges of the differences.

TABLE 4
PERSONNEL SERVICES MODEL
NUMBER OF AGENCIES WITH INCREASES AND DECREASES
IN PRO-RATA COSTS

<u>Difference</u>	<u>Agencies With Increases</u>	<u>Agencies With Decreases</u>
\$ 1-\$ 10,000	29	47
\$ 10,001-\$ 50,000	5	23
\$ 50,001-\$100,000	2	8
\$100,001-\$200,000	1	7
Above \$200,000	<u>4</u>	<u>8</u>
Total	<u>41</u>	<u>93</u>

A comparison of the results of our model and the department's current method of allocating costs for personnel and payroll services for two state agencies illustrates the difference between the two methods. Under our model, pro-rata costs allocated to the Department of Consumer Affairs increased \$1,163,381 (261 percent) compared to its allocation under the current method. In our model, the Department of Consumer Affairs represented 4.3 percent of the total state personnel positions; under the current method, it represented 1.2 percent of total state personnel years.

In contrast, the Department of Transportation's pro-rata costs decreased \$811,972 (21 percent) compared to its allocation under the current method. In our model, the Department of Transportation represented 8.1 percent of the total state personnel positions; under the current method, it represented 10.2 percent of total state personnel years.

III

CONCLUSION AND RECOMMENDATIONS

The Department of Finance's methods of allocating pro-rata costs appear reasonable and appropriate, with two exceptions. First, some of the costs for Health Benefits for Retired Annuitants are inappropriately allocated to all state agencies. Under the department's method, the costs allocated for HBRA include the costs for health benefits for retired judges and retired employees of district agricultural associations. However, the judges are not retirees of state agencies. Further, district agricultural associations are not state agencies and are not allocated pro-rata costs for HBRA. For fiscal year 1984-85, the costs for health benefits for retired judges and retired employees of district agricultural associations were approximately \$960,000 and \$337,000, respectively.

Second, the costs of providing personnel and payroll services to state agencies would be more equitably allocated on the basis of personnel positions rather than personnel years, as they are now. For fiscal year 1984-85, billable funds were allocated approximately \$831,000 more for personnel and payroll services to state agencies under the department's method than they would be under our model.

The department uses various workload measures to allocate the other pro-rata costs. Except for the pro-rata costs allocated for the

costs for HBRA and for the costs for personnel and payroll services to state agencies, the department's workload measures are equitable. Also, the department periodically adds new pro-rata costs or modifies the pro-rata calculation. These changes are made to comply with statutory requirements and to more equitably allocate pro-rata costs.

For the fiscal years 1979-80 through 1984-85, actual statewide pro-rata costs increased by \$148 million. HBRA was responsible for the greatest increase in pro-rata costs. The increase in the costs for HBRA was due primarily to inflation in health care costs. The increase also reflects growth in the number of annuitants participating in the health plan and the addition of the dental plan.

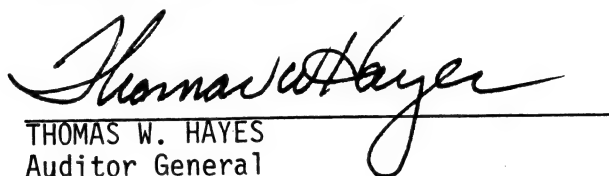
RECOMMENDATIONS

In allocating costs for Health Benefits for Retired Annuitants, the Department of Finance should include costs for retirees of state agencies only. The department should not include in the pro-rata allocation the State's costs for health benefits for retired judges and retired employees of district agricultural associations. The costs of health benefits for these retirees should be paid by the Judges' Retirement System and the district agricultural associations.

To more equitably allocate the central service agencies' costs to provide personnel and payroll services to state agencies, the department should use personnel positions rather than personnel years as the workload measure.

We conducted this review under the authority vested in the Auditor General by Section 10500 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,



THOMAS W. HAYES
Auditor General

Date: February 24, 1986

Staff: Philip Jelichich, CPA, Audit Manager
Jeffrey A. Winston, CPA
Linda A. McClendon
Arturo Ramudo

APPENDIX A

**PRO-RATA COSTS DETAIL BY WORKLOAD MEASURE
ACTUAL COSTS
FISCAL YEAR 1984-85**

<u>Central Service</u>	<u>Cost</u>	<u>Percent of Total</u>
Department of Finance Audits	\$ 3,635,089	1.39
Department of Finance Budgets	11,572,152	4.43
Office of Information Technology	1,639,230	0.63
State Controller Field Audits	2,913,774	1.12
Office of Administrative Law	2,309,696	0.88
Office of the Auditor General	6,619,309	2.53
Hours Worked	28,689,250	10.98
State Controller Accounting	3,577,804	1.37
State Controller Claims Audits	1,812,443	0.69
State Controller Payroll	1,558,041	0.60
State Controller General Disbursements	3,923,955	1.50
State Controller Retirement Warrants	115,410	0.04
State Treasurer Paying and Receiving	1,113,894	0.43
Documents Processed	12,101,547	4.63
State Controller - PPSD/SDD	18,114,115	6.94
State Personnel Board	14,660,685	5.61
Department of Personnel Administration	4,317,909	1.65
State Board of Control	723,757	0.28
Personnel Years	37,816,466	14.48
California Fiscal Information System	1,326,978	0.51
California State Accounting and Reporting System	5,157,681	1.98
State Treasurer Trust Services	224,940	0.09
Secretary of the Health and Welfare Agency	1,221,862	0.47
Secretary of the Youth and Adult Corrections Agency	687,269	0.26
Secretary of the State and Consumer Services Agency	611,599	0.23
Secretary of the Business, Trans., and Housing Agency	334,000	0.13
Secretary of the Resources Agency	1,104,180	0.42
Gross State Operations Expenditures	10,668,509	4.09
Health Benefits for Retired Annuitants	102,036,834	39.07
Current Employee Health Cost	102,036,834	39.07
State Treasurer Investment	763,006	0.29
Interest Earned	763,006	0.29
Legislature	69,095,828	26.46
Ratio of the Above Allocation	69,095,828	26.46
Total Actual Costs	\$261,171,440	100.00

**ACTUAL PRO-RATA COSTS
OF CENTRAL SERVICE AGENCIES
FISCAL YEARS 1979-80 TO 1984-85**

Central Service Agency	1979-80	Percent of Total	1980-81	Percent of Total	1981-82	Percent of Total	1982-83	Percent of Total	1983-84	Percent of Total	1984-85	Percent of Total
Department of Finance	\$ 12,653,263	11.17	\$ 19,207,466	13.33	\$ 22,436,949	12.32	\$ 21,467,473	11.08	\$ 20,769,819	9.09	\$ 23,331,130	8.94
State Controller	17,565,279	15.50	22,257,390	15.45	23,016,696	12.64	22,757,804	11.75	29,394,006	12.87	32,015,542	12.26
State Treasurer	1,423,820	1.26	1,583,277	1.10	1,450,403	0.80	1,389,001	0.72	1,528,509	0.67	2,101,840	0.81
State Personnel Board	13,060,778	11.53	15,260,306	10.59	19,349,276	10.69	15,243,000	7.87	15,618,943	6.84	14,660,685	5.61
State Board of Control	523,380	0.46	697,960	0.49	784,596	0.43	512,661	0.26	676,001	0.29	723,757	0.28
Health Benefits for Retired Annuitants	29,849,630	26.34	38,717,783	26.88	49,087,400	26.96	69,068,333	35.65	85,499,926	37.42	102,036,834	39.07
Office of the Auditor General	3,915,373	3.46	4,861,208	3.38	5,934,367	3.26	6,550,884	3.38	6,890,681	3.02	6,619,309	2.53
Legislature	34,311,859	30.28	41,460,020	28.78	57,153,089	31.39	54,177,980	27.96	60,524,154	26.49	69,095,828	26.46
Department of Personnel Administration					2,738,382	1.51	2,582,066	1.33	2,205,724	0.97	4,317,909	1.65
Office of Administrative Law									1,713,794	0.75	2,309,696	0.88
Secretary of the Health and Welfare Agency									1,139,546	0.50	1,221,862	0.47
Secretary of the Youth and Adult Corrections Agency									614,179	0.27	687,269	0.26
Secretary of the State and Consumer Services Agency									563,219	0.25	611,599	0.23
Secretary of the Business, Trans., and Housing Agency									285,000	0.12	334,000	0.13
Secretary of the Resources Agency									1,037,435	0.45	1,104,180	0.42
Total Actual Pro-Rata Costs	\$113,303,382	100.00	\$144,045,410	100.00	\$182,061,158	100.00	\$193,749,202	100.00	\$228,460,936	100.00	\$261,171,440	100.00
Actual Billable Costs	\$ 32,699,356	28.86	\$ 41,283,415	28.66	\$ 55,838,157	30.67	\$ 60,275,377	31.11	\$ 71,165,582	31.15	\$ 84,985,187	32.54
Actual Nonbillable Costs	80,604,026	71.14	102,761,995	71.34	126,223,001	69.33	133,473,825	68.89	157,295,354	68.85	176,186,253	67.46
Total Actual Pro-Rata Costs	\$113,303,382	100.00	\$144,045,410	100.00	\$182,061,158	100.00	\$193,749,202	100.00	\$228,460,936	100.00	\$261,171,440	100.00

APPENDIX B

**CHANGE IN ACTUAL PRO-RATA COSTS
FOR EACH CENTRAL SERVICE AGENCY
FISCAL YEARS 1979-80 TO 1984-85**

Central Service Agency	1979-80	1980-81	Percent Change	1981-82	Percent Change	1982-83	Percent Change	1983-84	Percent Change	1984-85	Percent Change
Department of Finance	\$ 12,653,263	\$ 19,207,466	51.80	\$ 22,436,949	16.81	\$ 21,467,473	(4.32)	\$ 20,769,819	(3.25)	\$ 23,331,130	12.33
State Controller	17,565,279	22,257,390	26.71	23,016,696	3.41	22,757,804	(1.12)	29,394,006	29.16	32,015,542	8.92
State Treasurer	1,423,820	1,583,277	11.20	1,450,403	(8.39)	1,389,001	(4.23)	1,528,509	10.04	2,101,840	37.51
State Personnel Board	13,060,778	15,260,306	16.84	19,459,276	27.52	15,243,000	(21.67)	15,618,943	2.47	14,660,685	(6.14)
State Board of Control	523,380	697,960	33.36	784,596	12.41	512,661	(34.66)	676,001	31.86	723,757	7.06
Health Benefits for Retired Annuitants	29,849,630	38,717,783	29.71	49,087,400	26.78	69,068,333	40.70	85,499,926	23.79	102,036,834	19.34
Office of the Auditor General	3,915,373	4,861,208	24.16	5,934,367	22.08	6,550,884	10.39	6,890,681	5.19	6,619,309	(3.94)
Legislature	34,311,859	41,460,020	20.83	57,153,089	37.85	54,177,980	(5.21)	60,524,154	11.71	69,095,828	14.16
Department of Personnel Administration											
Office of Administrative Law											
Secretary of the Health and Welfare Agency				2,738,382		2,582,066	(5.71)	2,205,724	(14.58)	4,317,909	95.76
Secretary of the Youth and Adult Corrections Agency								1,713,794		2,309,696	34.77
Secretary of the State and Consumer Services Agency								1,139,546		1,221,862	7.22
Secretary of the Business, Trans., and Housing Agency								614,179		687,269	11.90
Secretary of the Resources Agency								563,219		611,599	8.59
								285,000		334,000	17.19
								1,037,435		1,104,180	6.43
Total	\$113,303,382	\$144,045,410	27.13	\$182,061,158	26.39	\$193,749,202	6.42	\$228,460,936	17.92	\$261,171,440	14.32

APPENDIX D

PRO-RATA COSTS OF EACH CENTRAL SERVICE AGENCY PRIOR-YEAR ADJUSTMENTS FISCAL YEARS 1979-80 TO 1984-85

Central Service Agency	1979-80	Percent of Total	1980-81	Percent of Total	1981-82	Percent of Total	1982-83	Percent of Total	1983-84	Percent of Total	1984-85	Percent of Total
Department of Finance	\$ (910,095)	(6.17)	\$ 2,813,623	9.66	\$ 2,493,291	8.97	\$ (3,606,168)	(40.75)	\$ 329,094	9.12	\$3,037,759	63.78
State Controller	3,970,853	26.91	7,558,662	25.96	1,990,666	7.16	(961,348)	(10.86)	2,999,509	83.16	4,665,060	97.94
State Treasurer	(107,995)	(0.73)	642,099	2.21	(643,634)	(2.31)	(784,791)	(8.87)	(400,588)	(11.11)	310,845	6.53
State Personnel Board	825,852	5.60	1,411,649	4.85	3,969,342	14.28	498,000	5.63	(292,057)	(8.10)	(1,250,913)	(26.26)
State Board of Control	67,423	0.46	118,273	0.41	75,976	0.27	(87,490)	(0.99)	159,001	4.41	146,362	3.11
Health Benefits for Retired Annuitants									3,707,956	102.80	(2,074,435)	(43.55)
Office of the Auditor General	7,834,630	53.09	8,881,783	30.50	7,898,029	28.41	16,358,981	184.86	(669,319)	(18.56)	(1,279,482)	(26.86)
Legislature	1,655,373	11.22	561,208	1.93	766,017	2.76	(1,419,116)	(16.04)	291,654	8.09	3,606,206	75.71
Department of Personnel Administration	1,420,183	9.62	7,128,217	24.48	8,510,283	30.61	(1,941,755)	(21.94)	(835,276)	(23.16)	1,816,150	38.13
Office of Administrative Law					2,738,382	9.85	793,077	8.96	(281,206)	(7.80)	328,835	6.90
Secretary of the Health and Welfare Agency									(746,454)	(20.69)	(4,401,534)	(92.41)
Secretary of the Youth and Adult Corrections Agency									(39,821)	(1.10)	109,988	2.31
Secretary of the State and Consumer Services Agency									(23,781)	(0.66)	65,689	1.38
Secretary of the Business, Trans., and Housing Agency									(529,048)	(14.67)	(437,416)	(9.18)
Secretary of the Resources Agency									(62,565)	(1.73)	117,776	2.47
Total Prior-Year Adjustments	\$14,756,224	100.00	\$29,115,514	100.00	\$27,798,352	100.00	\$8,849,390	100.00	\$3,607,098	100.00	\$4,762,890	100.00

Prior-Year Adjustments as Percent of Actual Pro-Rata Cost

13.02%

15.27%

4.57%

1.58%

1.82%

APPENDIX E

**PRO-RATA COSTS AS PERCENT
OF STATE OPERATIONS
SELECTED FUNDS
FISCAL YEARS 1979-80 TO 1984-85**

<u>Fund Name</u>	<u>Fiscal Year 1979-80</u>	<u>Fiscal Year 1980-81</u>	<u>Fiscal Year 1981-82</u>	<u>Fiscal Year 1982-83</u>	<u>Fiscal Year 1983-84</u>	<u>Fiscal Year 1984-85</u>	<u>Average</u>
Department of Agriculture Fund, Department of Agriculture Account	3.10%	2.48%	2.34%	3.16%	3.79%	2.92%	2.97%
State Banking Fund	2.50	2.72	3.23	3.27	3.75	3.52	3.17
Fish and Game Preservation Fund	2.09	2.36	2.79	2.94	3.57	3.27	2.84
Insurance Fund					3.16	3.61	3.39
Real Estate Fund	1.35	2.90	3.18	3.58	3.41	2.90	2.89
Savings Association Special Regulatory Fund	2.26	2.42	3.56	4.57	4.15	4.03	3.50
Teacher Credentials Fund	2.89	3.46	4.34	3.54	4.37	3.92	3.75
Transportation Rate Fund	1.97	2.27	3.53	2.91	4.02	3.24	2.99
Accountancy Fund	1.59	2.87	3.61	2.69	2.67	2.66	2.68
Contractors' License Fund	2.88	2.54	3.53	3.30	3.58	3.67	3.25
State Dentistry Fund	1.46	2.77	3.71	3.22	5.12	2.99	3.21
Contingent Fund of the Board of Medical Quality Assurance	2.54	2.55	3.66	2.91	3.36	2.99	3.00
Average of All Funds	2.24%	2.67%	3.41%	3.28%	3.75%	3.31%	3.14%

APPENDIX F

**A COMPARISON OF METHODS
TO ALLOCATE PRO-RATA COSTS
EFFECTS ON BILLABLE AND NONBILLABLE FUNDS
FISCAL YEAR 1984-85**

<u>Health Benefits for Retired Annuitants</u>	<u>Billable Funds</u>	<u>Nonbillable Funds</u>	<u>Total</u>
Department of Finance's method	\$33,389,389	\$68,647,456	\$102,036,845
Our model	<u>34,440,053</u>	<u>67,596,792</u>	<u>102,036,845</u>
Increase (decrease) in costs for Health Benefits for Retired Annuitants	<u>\$ 1,050,664</u>	<u>\$(1,050,664)</u>	<u>\$ 0</u>
Percent increase (decrease)	3.1	(1.5)	

<u>Services To Meet the Personnel and Payroll Needs of State Agencies</u>	<u>Billable Funds</u>	<u>Nonbillable Funds</u>	<u>Total</u>
Department of Finance's method	\$12,906,018	\$24,910,327	\$37,816,345
Our model	<u>12,075,072</u>	<u>25,741,273</u>	<u>37,816,345</u>
Increase (decrease) in costs for services to meet the personnel and payroll needs of state agencies	<u>\$ (830,946)</u>	<u>\$ 830,946</u>	<u>\$ 0</u>
Percent increase (decrease)	(6.4)	3.3	

DEPARTMENT OF FINANCE
OFFICE OF THE DIRECTOR
SACRAMENTO, CA 95814-4998



FEB 20 1986

Mr. Thomas W. Hayes, Auditor General
Office of the Auditor General
660 J Street
Sacramento, CA 95814

Dear Mr. Hayes:

We have reviewed the draft copy of your report (February 13, 1986) entitled "Some Pro-Rata Costs Could be More Equitably Allocated" and provide the following comments.

We agree with your conclusion that the Department of Finance's methods of allocating pro rata costs overall are reasonable and appropriate with only two exceptions: (1) a portion of the costs for Health Benefits for Retired Annuitants and (2) the workload used to allocate the costs for providing personnel and payroll services. To more equitably allocate pro rata costs, your report also contained recommendations regarding these two exceptions.

The Department of Finance continually reviews the methods of calculating pro rata costs to determine whether the methods used to assess pro rata costs to departments are appropriate and reasonable. We have reviewed your recommendations and believe that they are appropriate and reasonable.

We will attempt to implement your recommendations in the next pro rata cycle which will be for fiscal year 1987-88.

If you wish to discuss this issue further, please contact Barry L. Rockwell, Chief, Fiscal Systems and Consulting Unit, at 445-4638.

Very truly yours,

A handwritten signature in black ink, appearing to read "Jesse R. Huff".

JESSE R. HUFF
Director of Finance

FS:556

cc: Members of the Legislature
Office of the Governor
Office of the Lieutenant Governor
State Controller
Legislative Analyst
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Majority/Minority Consultants
Capitol Press Corps